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No. 5

Depreciation on Appreciation

SCOPE OF THIS STATEMENT

1. The committee has given extended consideration to the question of the proper accounting for depreciation on appreciation. The research staff has studied the available literature, and has caused several special memoranda to be prepared. The committee has discussed the subject at three of its meetings, and by correspondence.

As a result the committee now makes a definite recommendation with respect to the charge to be made against income in such cases, but has as yet developed no definite recommendations on other aspects of the problem. It has therefore been considered useful for the committee to issue this statement of its conclusion as to the proper charge against income, and to add thereto a discussion of other relevant questions. The latter discussion will, it is hoped, be helpful in furthering the formulation of conclusions on these other questions.

2. Accounting for fixed assets should normally be based on cost, and any attempt to make property accounts in general reflect current values is both impracticable and inexpedient. Appreciation normally should not be reflected on the books of account of corporations. The problem which the committee here considers is the treatment of charges against income where appreciation has in fact been entered on the books.

3. The word "depreciation" is here used in its ordinary accounting sense and not as the converse of "appreciation".

This discussion does not deal with cases in which the value of property may exceed the amount at which it is carried on the books because of increment due to lapse of time—such as the growth of timber, or to such causes as solidification or adaptation—as of the roadbed of a railroad or a dam, or by reason of excessive allowance for depreciation in the past. On these cases no opinion is here expressed or implied. This bulletin is concerned primarily with appreciation due to (1) increases in the relevant price levels, or (2) demonstration that the property has greater usefulness than is reflected in the amount at which it is carried in the books, as discussed later in paragraphs 11 and 12.

CONCLUSION AS TO CHARGE AGAINST INCOME

4. The committee is of the opinion that when such appreciation has been entered in the books, income should be charged with depreciation computed on the new and higher values. This proposition is the most important part of the present statement and for it there seems to be general support. A corporation should not at the same time claim larger property values in its statement of assets, and provide for the amortization of only smaller property sums in its statement of income.

5. It is recognized that in the past the contrary view has been held in the profession and in other authoritative quarters, and in some cases it may be unreasonable to require a corporation to change a treatment adopted in good faith in the past. The committee believes, however, that a change to conform to the views now expressed is very desirable, and that members of the Institute should exercise their influence to the utmost to bring about such changes.

Discussion of Conclusion

6. From the strictly accounting point of view the depreciation charge against income is the element of primary importance. It should fairly reflect the consumption or expiration of property usefulness that has taken place.

The conclusion does not rest upon any basis of narrow logic or precise classification; it is derived from considerations of equity and public policy of the broadest character. These include an application of something analogous to the legal doctrine of estoppel, which asserts that one who has made certain representations is thereby precluded from afterwards averring anything inconsistent with them. In the present case this would mean that a company which has made representations as to an increased value of plant cannot afterwards account for depreciation and income as if it had never made such representations. When a company has made representations in its balance sheet as to an increased value of its property and others have bought its securities upon those representations, it is not unreasonable to interpret the formal adoption of the larger amount for plant as implying an intention on the part of the company to maintain that larger amount of invested capital intact by proper charges against income. To implement such intention it is necessary that the company charge income with depreciation on the larger values represented.

7. If securities have been issued on the basis of a prospectus in

which the higher values were claimed, there may be a legal, and there would certainly seem to be a moral, obligation to provide for depreciation of the property on the basis of these higher figures in arriving at the amount of profits available for distribution. Even if no prospectus has been issued, but the corporation has sought a market for its securities by listing them on an exchange, so that the new values have been shown in published annual reports, similar considerations may today be regarded as applicable. It may reasonably be argued that new purchasers of securities of the corporation are led to acquire them upon the understanding that the higher values already exist and have been given formal recognition, and therefore form a part of the values which they acquire by their purchase of the stock, and that consequently they may be misled if dividends are subsequently paid to them on the basis of earnings computed with depreciation charged on original cost.

DISCUSSION OF OTHER ASPECTS OF THE PROBLEM

The following paragraphs deal largely with questions upon which, as stated above, the committee has as yet reached no conclusions. Most of these paragraphs do not represent opinions of the committee as a whole, but set forth the conflicting considerations which require careful study before more extended conclusions can be reached.

Accounting for Fixed Assets

8. The view expressed in paragraph 2 relates to accounts which form the basis for reports to stockholders and similar statements. Manifestly, there is no objection to showing estimated present values, nor to the computation of depreciation on that basis, for internal administrative purposes. A distinction can be made between the internal accounting for an enterprise and the accounting for the corporation which carries on the enterprise. From the standpoint of the enterprise, cost to the corporation is not of controlling significance, but, to the corporation itself, cost is the proper foundation of its accounting.

9. It must be recognized that in many cases appreciation has already been recorded on the books; it seems desirable, if practicable, to develop a standard procedure in such cases. In addition, instances occasionally arise in which appreciation is relatively so large and so well assured that it may be permissible from an accounting standpoint, and desirable upon more general grounds, to record it in the books. It should be added that in many cases the object sought could be better obtained by explanatory notes.

10. The cases of mines and industrial enterprises are not entirely analogous, but consideration of the problem of mine depletion furnishes an illustration which may be helpful in dealing with the more complex problem of an industry. It is of course recognized that mines are often not legally required to make, and do not make, depletion charges.

The capital value of a mine is, in theory, the sum on which the mine may be expected to yield a fair return after provision has been made for amortization of that capital value. The accounting basis will normally be cost, but where the present value of future income is very greatly in excess of the unamortized part of the cost of the mine to the corporation which owns it, a balance sheet of the corporation in which the properties are stated at cost may be less useful to the average investor than a balance sheet in which the properties are stated at a figure more nearly commensurate with existing values, and on which depletion is computed accordingly. In this, as in industrial cases, there is considerable question as to whether the situation cannot best be shown in the form of supplementary information not included in the accounts.

It has been suggested that one method of including the appraisal in the balance sheet with the least disturbance is to show the entire balance sheet on a cost basis, with totals, and then to add on the assets side the unamortized amount of the property appraisal increment, and on the liabilities side the corresponding appraisal credit.

11. Comparable cases arise in industrial practice only when an extreme inflation occurs, or when assets have been acquired at an abnormally low cost. It is not necessary here to discuss the former case; that might call for reconsideration of many practices followed in more normal times. It may be useful, however, to examine the case of a property acquired at an abnormally low cost, the appropriate treatment of which turns to a considerable extent on the importance attached to different functions of accounts.

12. If in such case operations are charged with depreciation based on the low cost, the result will be to include in earnings from operations a profit which is in reality due to the exceptional character of the original purchase. It may be conceded that this profit is realized and available for dividends, but some hold the view that a clearer picture of the efficiency of the management will be presented if operations are charged with a provision for depreciation on a fair going concern value.

Treatment of Earned Surplus after Revaluation Entry

13. Some of those who feel it to be permissible or even necessary to charge operations with depreciation based on the higher appraisal value, would nevertheless like to have the final earned surplus reflect depreciation on original cost. These results might be attained by (1) charging operations with depreciation based on the revised book figure; (2) carrying to earned surplus as a separate credit the excess of the depreciation charged to operations over depreciation based on cost, with a corresponding charge to the revaluation credit account.

14. Assuming this view to be accepted, the questions would remain whether the credit last mentioned should reach earned surplus through income account or directly, and whether it should be deemed to be a part of the free earned surplus or should be regarded as appropriated earned surplus. If the arguments advanced in paragraph 6 are sound, so that a company which has written up its property values is deemed to be bound to charge income with the depreciation on the larger values represented, it is not proper to undo the effect of such a charge by making a transfer from the revaluation credit to income account. The conclusion reached in paragraph 4 requires that no such credit be made. Upon the same reasoning, even if the credit is conceded to form a part of earned surplus, it would seem that it should not form the basis of ordinary dividends, but should be regarded as appropriated surplus, or made the basis of dividends specifically described as to the source from which they are paid.

Treatment of Revaluation Credit Account

15. It was noted in paragraph 13 that some accountants favor regular periodic transfers from the appraisal credit to earned surplus, of amounts equal to depreciation on the appreciation recorded. Others argue that the appraisal credit should remain until disposed of by special action. Examples of such action would be: (1) transfer to capital stock by means of a stock dividend; (2) transfer to earned surplus, when appraised units are retired, of the amount of appraisal credit which has been realized with respect to such retired units; (3) lump-sum transfers to earned surplus, in amounts not exceeding the appraisal credit actually realized. Amounts transferred under (2) and (3) might perhaps be separately stated as a subdivision of earned surplus, appropriately described to indicate their source and nature.

16. When plant is stated at an increased value on the assets side of the balance sheet, should that increased amount of assets be regarded as implying an equivalent increase in "capital" as used in a restricted sense on the liabilities side of the balance sheet? Obviously it does not necessarily signify an increase in the legal stated capital; but some contend that it implies an increase in the unstated capital, in capital surplus in other words. To this it is sometimes added that capital surplus is just as much "capital" as capital stock—a proposition which is economically sound, but is subject to legal limitations which, since a corporation is the creation of law, the accountant cannot ignore.

17. Those who take this view say that the write-up has the effect of a quasi-reorganization—that it is an upward restatement of capital on the liabilities side, as well as of plant on the assets side. Accepting that view would mean that the credit item would be regarded as part of the capital structure, and not as available for transfer to earned surplus. Some go further and assert that an upward restatement of assets should not be entered in the books unless the management regards the situation in this light and is prepared to accept the consequences as stated. These consequences include, according to this view, not only the charging of income with depreciation on the larger amount—a point on which, as stated, there is general agreement—but also the "freezing" of the resultant credit item until it is disposed of, if at all, into capital stock by means of a stock dividend.

18. Those who do not share the foregoing views find their point of departure in the nature of the representations made when the appraisal value is entered. They hold that the representation is merely of the present value of the plant, and not of the nature of the resulting credit item, at any rate not to the extent of classifying it definitely as capital. They regard the credit as a sort of suspense item, the true nature of which is to be determined by the future course of events, and to be assigned to earned surplus, or by stock dividend converted to capital stock, as circumstances may require. Others deny that the credit is a capital increase, and assert that it is merely an unusual profit, to be distinguished from ordinary operating profits.

Other Considerations

19. Certain other difficulties may be touched upon. It is not possible to make a general statement as to the legal standing of appraisal figures. This varies in different jurisdictions, and for different purposes. For example, appraisal figures usually have no recognition for income-tax purposes. However, there are exceptions, such as the March 1, 1913 values adopted as a starting point. Some state statutes recognize unrealized appreciation as a basis for asset values and for certain types of dividends. Regulatory commissions tend to favor cost as the basis of property accounting, but for other purposes consideration has frequently been given to appraisals, the degree depending on the circumstances of the particular case. The attitude of the S. E. C. on the question is not yet fully developed, its decisions in this area having involved chiefly the question whether a given appraisal was fair and reasonable.

20. The committee is not yet prepared to adopt any one of the foregoing viewpoints to the exclusion of the others. It may be that varying circumstances will in any case require that alternative treatments be available. The committee hopes to return to this subject at a later date when further discussion and experience have clarified the issues.

21. Appendices A and B give some factual information with respect to the problems discussed in this paper.

Appendix A contains data concerning the balance-sheet treatment of property items, based on a study of 500 balance sheets for 1938.

Appendix B quotes from a published source some figures showing (a) the amounts of write-ups and write-downs for a ten-year period, and (b) the number of corporations making such write-ups or write-downs, both based on a study of 272 corporations.

APPENDIX A

Practice with Respect to Carrying Values of Fixed Assets and Statement of Capital Surplus or Equivalent Items

A study of 500 published balance sheets for 1938 shows:

On Assets Side

Of the 500 balance sheets, 480 contained one or more property items to the number of	562
Of these 562 property items:	
Number described as at cost, at cost less reserves, or acquisition values	251
Number described as appraised or revised values—in various forms	135
Other captions (most frequent being "book values"—33)	75
No basis of valuation indicated	101
Total property items	562

On Liabilities Side

Of the 500 balance sheets, 321 contained items of capital surplus or equivalent items to the number of	332
Of these 332 items of capital surplus:	
Number described as "capital surplus"	239
Number described as "paid-in surplus" or equivalent terms	57
Number described as arising from revaluation or appraisal	10
Number described as acquisition surplus, conversion surplus, etc.	26
Total capital surplus or equivalent items	332

APPENDIX B

The following tables have been taken from *Capital Consumption and Adjustment*, by Solomon Fabricant, a publication of the National Bureau of Economic Research. They furnish some conception of the extent of write-ups and write-downs.

Write-ups and Write-downs of Property, Plant and Equipment, 1925–1934 [1]

272 Large Industrial Corporations (Unit: $1,000)

	Write-ups	Write-downs	Net Write-ups
1925	28,309	12,813	15,496
1926	65,944	24,356	41,588
1927	23,248	16,432	6,816
1928	26,255	68,429	−42,174
1929	14,359	128,578 [2]	−114,219
1930	24,392	16,723	7,669
1931	5,924	194,686	−188,762
1932	23	251,468	−251,445
1933	123	117,315	−117,192
1934	77	117,426	−117,349

Corporations reporting Revaluations of Property, Plant and Equipment, Number, 1925–1934 [3]

	Total [4]	
	Write-ups	Write-downs
1925	12	10
1926	13	13
1927	14	11
1928	16	16
1929	12	15
1930	8	23
1931	4	48
1932	1	55
1933	2	44
1934	1	27

[1] Table 43 (page 213).
[2] Including 113 millions for United States Steel Corporation.
[3] Table 45 (page 215).
[4] Out of 272 corporations examined.

The statement entitled "Depreciation on Appreciation" was adopted by the assenting votes of eighteen members of the committee. Four members, Messrs. Blough, Couchman, Fernald and Paton dissented.

The grounds for dissent were varied. Without giving a full discussion of these, the main points may be stated. Mr. Blough dissented with respect to paragraph 5; in his opinion the rule in paragraph 4 should be applied at once in all cases. Mr. Couchman dissented on the ground that he would prefer to return more strictly to the cost basis, rather than allow further departures therefrom. In cases where appreciation has been entered in the books, he would prefer that the appraisal credit be deducted from the appraised value in the balance sheet, thus restoring it to a cost basis. Mr. Fernald dissented as to the legal implications of paragraphs 6 and 7, considering that financial statements do not constitute any representation or commitment that invested capital will be maintained intact or dividend payments will be limited except only as applicable law may from time to time prescribe. Mr. Paton does not approve of any departure from the cost basis for depreciation charged in determining the final net income figure reported, except in cases where the appraisal is a feature of a formal or quasi-reorganization.

Mr. Fedde assented to the paper with the proviso that depreciation based on appreciated property values be charged in two amounts, (1) depreciation on cost, and (2) depreciation on appreciation.

NOTES

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)

2. Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)